

Notes For Remarks

## Canada's Aviation Restructuring: Impact on Airports

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Good afternoon, ladies and gentlemen. Thank you for inviting me to Washington to address your group on aviation issues. Canada is going through a very exciting period of change and so it is an opportune time to talk to you about what is happening north of the border. I am here to tell you that even though Canada is both close and in some ways very familiar, there is much about our country that is a well-kept secret.

Many of the figures of your popular culture are in fact not American but actually Canadians, although you may not realize it. These include:

Neil Young, the late Lorne Greene, Don Carty, Mary Pickford, Joni Mitchell, Michael J Fox, James Cameron, the late John Candy and more recently Mike Myers. Myers popular as Austin Powers perhaps gives away his Canadian identity with the line: "If he were any cooler he would still be frozen." And how can we forget David Letterman's sidekick, Paul Shafer!

What I'd like to do today is take you on a trip through some of the little known facts about our environment for airports and carriers. Specifically, I'd like to tell you about the relative and absolute importance of Toronto as a major North American hub airport, the potential of Vancouver as a Pacific gateway and the dramatically improved competitive climate that our air carriers face. Finally, I'd like to answer two questions: What is the outlook for the Canadian air industry? And is Air Canada an unconstrained monopolist?

Now, in the classic brokerage fashion, before I go any further, I have a disclosure to make: Since a lot of my talk is going to touch on Air Canada, I'd like to point out that I was involved very directly in the recent battle for Canada's skies. In August 1999, Airco, a subsidiary of Onex Corporation launched an offer to purchase all the common shares of both Air Canada and Canadian Airlines. My firm, National Bank Financial, was an advisor to the Airco group. Most of you in this room probably know the result. On November 5, 1999, a Quebec Superior Court judge ruled that the Airco bid was illegal because it violated the 10% shareholding limit contained in the Air Canada Public Participation Act, the statute under which Air Canada was privatized in 1988. As a result, the bid by Airco was withdrawn.

The result of the withdrawal was that Air Canada is in the final stages of successfully completing the counterproposal that it had put before the Canadian people, its Parliament and the shareholders of Air Canada and Canadian Airlines. Under the proposal Air Canada purchased back about one third of its shares and through a partially owned numbered company has purchased over 80% of Canadian Airlines common shares for \$2.00 per share. More recently, Paul Brotto, an Air Canada veteran, replaced Canadian's Chief Executive Officer Kevin Benson.

Having declared my involvement, it is nevertheless this finale to the Airco story that will have a very definite impact on the environment for airports in Canada – the subject of my talk today.

Let's start with the competitive environment: The process to revise the competitive environment, making it less competitive but more hospitable to our major carrier, is now nearing completion. Specifically, we are now moving toward a single hub-and-spoke network carrier in Canada to exploit the opportunities at both the Toronto and Vancouver hubs. Both hubs will operate an integrated network to maximize benefits for all Canadian travelers, rather than steering passengers on to one network or the other. I believe that the business travelers based in Vancouver should be the largest beneficiaries.

However, in the short term we will see a reduction in flying from many smaller airports in Canada, Hamilton, near Toronto, being one exception. It is designated as the stepping stone for eastern expansion for our Southwest Airlines look-alike, WestJet. Hamilton by the way is located about 60 miles west of Toronto.

Let me begin by talking about the historical backdrop against which our current events must be interpreted. In the United States, everybody goes back to the Chicago convention of 1944, as the beginning of all international air travel developments. We go back a little farther. The founding of Trans-Canada Airlines in 1937 as a subsidiary of the Canadian National Railway was important in many respects. It established TCA, the precursor of Air Canada, as the Canadian Crown carrier that would bear the responsibility of being the tool of government air policy. Attempts in the 1940s to establish Canadian Airways as a competitor to Air Canada, were met by various degrees of resistance by the government, which naturally wanted to do nothing to prejudice the value and the future of the crown carrier. This trend continued with various levels of mitigation until 1976, when the restrictions on domestic competition by Canadian Pacific Air Lines were largely removed. As the United States in 1978 deregulated its air travel market, we watched with interest. Our deregulation was completed ten years after the United States and with several key differences. To begin with, our experiment was completed with a very unequal opening position of the opening players. Unlike the US, where there were about 10 trunk carriers, including three with major international route networks in a battle for the consumer travel dollar, Canada had two major carriers with one clearly dominant domestic and international player in Air Canada. Twelve years of competition did not significantly shift the ground from where the players started, with Air Canada in the much stronger market position. Canadian neither possessed nor acquired the international or domestic mass to fend off the much larger Air Canada.

The Canadian market is a very concentrated one - much more so than the United States. The result is that the top six airports in Canada account for eight of the top ten routes and 75% of the traffic. The result is that even Canadians often underestimate the absolute and relative importance of Toronto.

## Map and table of top 10 domestic O & D

### Canadian Domestic Traffic Flows

Traffic in these 8 major Canadian cities have represented over 80% of all Canadian arriving and departing passengers in recent years.



### Percentage of traffic, 1996

AIRPORT	CDNSHARE
Toronto (Pearson)	30.7%
Vancouver	17.8%
Calgary	9.0%
Montreal (Dorval)	8.3%
Hamilton	0.13%
US MARKET SHARE	
Chicago (O'Hare)	5.5%
Atlanta (Hartsfield)	5.4%
Dallas/ Ft. Worth	4.8%
Los Angeles	4.1%
San Francisco	2.9%
Denver	2.7%
Phoenix	2.7%
Las Vegas	2.5%
Newark	2.3%
Miami	2.1%
New York JFK	1.7%
New York La Guardia	1.7%

### Top Ten Cities by Percentage of Transborder Traffic, 1997

AIRPORT	SHARE
Toronto	19.2%
Vancouver	9.0%
Montreal	7.6%
New York	6.4%
Los Angeles	4.7%
Calgary	4.2%
San Francisco	3.3%
Chicago (O'Hare)	3.0%
Ottawa	2.4%
Miami	2.2%

Pearson Airport in Toronto accounts for a very significant portion of Canadian air traffic. It handles over 30% of Canada's national air traffic, which is proportionately far ahead of Chicago, Atlanta, Dallas, Los Angeles and San Francisco combined. As well, Toronto airport deals with over 19% of the trans-border traffic, greater than New York (6.8% combined), Los Angeles (4.5%), San Francisco (3.2%) and Chicago (3.0%).

### North American Airports by Principal Function

	United States	Canada
Largest airport	Chicago	Toronto
Largest single carrier hub	Atlanta	Toronto
Largest mid-continent hub, controlled by a single carrier	Dallas/Fort Worth	Toronto
International airport for the largest city	New York JFK	Toronto
Domestic airport for the largest city	New York La Guardia	Toronto
	Miami	Toronto
Gateway to Latin America		
Gateway to Europe	New York JFK	Toronto

Toronto alone fills most of the principal functions that are currently held by many American airports. In Canada, it is the largest airport, as Chicago is in the United States. It is the largest hub controlled by a single carrier, as Atlanta is. It accommodates both domestic and international traffic for Canada's largest city, functions shared in the US by JFK and La Guardia. And it is also Canada's gateway to Europe and to Latin America, as JFK and Miami respectively are for the US.

Toronto was already established as a major international hub with approximately 24 domestic spokes, 35 US ports and 18 international destinations. Indeed Air Canada is talking of adding over 10 more international destinations.

Now while these tables have shown that Toronto is clearly dominant in the Canadian world, it is worth seeing where Toronto ranks in a North American context.

Based on 1998 data, Toronto (Pearson) currently ranks eighth in North America in terms of total locally originating passengers, but Air Canada's 43 percent share of these passengers means that it ranked only eleventh among North American hub carriers in terms of total local passenger bookings. Based on 1998 figures Air Canada's share of local passengers at Toronto pro forma the combination with Canadian would be 59

percent. On this basis, Air Canada's hub operations at Toronto will now rank as the sixth largest in North America.

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Toronto was already established as a major international hub with approximately 66 domestic spokes and 27 international destinations. Indeed Air Canada is talking of adding over 10 more international destinations. Internationally, Air Canada's 27 international destinations offered from Toronto now surpass Delta's 23 international routes out of Atlanta Hartsfield. (And it was Delta at Atlanta that offered more international routes by a single carrier than any other US airline at any other airport.) In trade talk this has a straightforward implication: Combine this powerful international presence with the cheap dollar – which never hurts – and this may well induce US traffic through Toronto to international destinations.

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Toronto is going through a transition as the relatively new Greater Toronto Airport Authority is adding a runway and reconstructing the current Terminal One and Two complex. In 1999, Air Canada sought to rein in the GTAA as it saw the planned expansion as a major cost at its main hub over which it sought to have greater input and control. Since the appointment of Robert Milton as President and CEO the temperature of the rhetoric has cooled considerably and the GTAA has reached agreement with Air Canada on key issues such as the consolidation of Canadian and Air Canada at Terminals One and Two. This seems to point to a less adversarial relationship between the largest carrier and its largest landlord.

**Local Traffic at Hubs in Canada Compared to U.S. Hubs Before Merger of Air Canada and Canadian**

RANK	HUB	CARRIER	CARRIER BOOKINGS	HUB TOTAL	SHARE
1	Atlanta	Delta	13,958,007	21,389,235	65%
2	Chicago (O'Hare)	United	12,366,936	29,379,587	42%
3	San Francisco	United	10,933,488	23,924,255	46%
4	New York (Newark)	Continental	10,903,576	21,584,559	51%
5	Dallas/ Ft. Worth	American	10,796,179	18,407,470	59%
6	Denver	United	8,910,681	15,015,645	59%
7	Los Angeles	United	8,350,508	34,775,095	24%
8	Miami	American	8,199,935	20,958,046	39%
9	Chicago (O'Hare)	American	8,040,698	29,379,587	27%
10	Houston (Bush Intercontinental)	Continental	7,115,751	11,483,778	62%
11	Toronto (Pearson)	Air Canada	6,898,945	16,110,155	43%
12	Detroit (Metro)	Northwest	6,816,568	12,169,896	56%
13	Minneapolis/St. Paul	Northwest	6,365,183	10,878,833	59%
14	Philadelphia	US Airways	5,536,050	10,851,252	51%
15	Seattle/Tacoma	Alaska	4,400,691	13,358,968	33%
16	St. Louis	TWA	4,319,072	7,638,651	57%
17	Salt Lake City	Delta	4,011,459	6,536,288	61%
18	Phoenix	America West	3,701,655	12,329,082	30%
19	Washington (Dulles)	United	3,682,907	8,550,552	43%
20	Pittsburgh	US Airways	3,625,482	5,494,674	66%

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15	Vancouver	Air Canada	4,823,604	8,595,238	56%

16	Seattle/Tacoma	Alaska	4,400,691	13,358,968	33%
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## **Vancouver**

Let's move now to Western Canada, to Canada's Asian Gateway – Vancouver. The development of an Asian gateway hub in Vancouver is an important asset for employment and trade prospects for the Province of British Columbia and the lower mainland of B.C. With the Air Canada exclusive routes to Osaka and Seoul added to Canadian's existing routes to Tokyo, Beijing, Taipei and Hong Kong, there is a strong Asian base for traffic into North America. Vancouver is very well positioned on the great circle route from North America to Asia over the Alaska routing that most US flights fly.

The benefits likely to accrue to Vancouver as an enhanced hub were a leading source of value creation under the proposal to combine our two carriers. Hubs create utility for organizations resident at the hub city. More flights create a virtual circle of increasing traffic, more opportunities, and longer and more frequent spoke connections. These in turn result in more flights and traffic. The resulting enhancements in trade and commercial opportunities create high value jobs. Vancouver, with greatly increased domestic feed from Toronto, can become a leading regional hub similar to Miami. Miami has become the regional travel hub to South America and the result is a constant flow of South American tourist visiting doctors, dentists, bankers, lawyers and consultants in Miami. With Vancouver's Asian linguistic capabilities, cultural diversity and geographic position at the northwest corner of North America, the potential is tremendous. Increased feed from Eastern Canada could lead to additional routes from Vancouver to cities like Guangzhou, Singapore, Kuala Lumpur and more U.S and Mexican destinations.

Air Canada's hub at Vancouver will improve its share of total passenger bookings at Vancouver to 56 percent, making its hub operations in Vancouver the fifteenth largest in North America.

As well, Air Canada has service to New Zealand and Australia over Honolulu and the carriers are starting to use their metal for the Australia portion of these routes.

Vancouver has a good community of interest with Canadian domestic points and also with the Californian centres of Los Angeles and San Francisco. In addition Canadian flew to Chicago and Dallas. Other routes that are likely to succeed include Denver, Las Vegas and San Diego.

## **Montreal**



Montreal is another airport that will benefit from the combination of the two airlines, although less than Toronto where the overcapacity was more pronounced before. The combination of domestic operations at Dorval with the international operations recently moved from Mirabel will do more to allow Montreal to become a secondary Canadian gateway for both Canadian and US passengers.

## **Hamilton**

Sixty miles from Toronto, this is perhaps the only airports in the world with no jet passenger service (although there are no regulatory constraints) and a capacity problem, gate restrained. This might well change now that WestJet, our Southwest look-alike, has announced that it will use it for its eastern expansion and fly six a days a week from Hamilton to Thunder Bay, Winnipeg, Montreal, Ottawa and the city of Moncton in New Brunswick.

Hamilton touts its great potential to better service customer bases such as London, St. Catharines, Niagara Falls, Kitchener, Burlington and naturally Hamilton – all of them medium to large centers in Southern Ontario. Approximately, 1.7 million people reside closer to Hamilton than Toronto and 3.2 million people are situated within a 60-minute drive of the Hamilton Airport. Elsewhere in North America we have seen that once 25 million passengers per year use an airport, a secondary airport can be supported. There are many examples in North America of cities supporting at least two airports – the classic examples being New York and Chicago, among others. And the population density surrounding Hamilton would certainly provide at the very least an outlet to Toronto. Indeed, Westjet has very successfully created an alternative airport in British Columbia and the lower mainland by using Abbotsford as an alternative to Vancouver for passengers in the Fraser valley. Hamilton might succeed on a parallel basis.

## **What then is the outlook for this industry's structure?**

With the combination of Air Canada and Canadian well underway, the competitive climate has clearly changed. Air Canada is now firmly entrenched as the dominant hub-and-spoke network business carrier for Canada, and it will difficult for competitors to emerge at the dominant hubs of Toronto and Vancouver. As well, WestJet, which was the low cost upstart carrier in Western Canada, has gone national and has announced a comprehensive fleet renewal strategy. It will not become a hub-and-spoke carrier, but it is clearly emerging as a significant force with a new fleet, much like Southwest after it established a presence. In addition, WestJet has the advantages of incumbency in many Western markets.

Air Canada meanwhile is expected to show dramatically improved profitability as its domestic yield improves with capacity reduction and international growth from consolidation of the Canadian international route network. Along with its role in the Star

Alliance, the international route consolidation should allow Air Canada to see improved financial performance for several years as the rationalization takes place. While this industry will remain cyclical, the less competitive environment should damp some of the cyclical swings that have been so dramatic in the past. This should benefit investors in Air Canada and in Westjet.

Then there are several other aspects of the Canadian picture that are not yet clear. For instance, what is the role of our charter carriers, which do offer scheduled services in Canada? I would say that as supplementary carriers their prominence is expected to increase. They may selectively pursue opportunities at Canada's secondary airports as the industry consolidation makes it feasible to do so.

Then, we have not seen what the other international alliances, especially the oneworld alliance, will do in response to the loss of its partner at Canadian Airlines.

**And finally, does all this add up to Air Canada becoming an unconstrained monopolist?**

A persistent question that continues to make the rounds of Canada is whether Canadian travelers will be gouged by Air Canada? Several observations are in order in answer to this. First, we have a transport minister who has introduced a comprehensive package of protective legislation that for the first time will give us effective statutory mechanisms to deal with predatory pricing. Secondly, we still have a number of competing carriers that will offer the leisure traveler some alternative choices and provide significant price competition. Finally, we need to look at the North American industry structure to see what the relative market share of Air Canada will be at its hub airports. The answer is that Toronto and Vancouver will certainly be world class North American scale hub airports. And the advantage for the STAR Alliance will be pronounced. The STAR Alliance will be dominant at five of the top eight hub airports in North America. But the relative strength of Air Canada after integration with Canadian will not be significantly different from the strong position of any other hub-and-spoke carrier in North America. While this should enable Air Canada to achieve the improved margins that it has sought for some time, the end result will not be a carrier that falls outside the norms of the North American hub-and-spoke network carriers.